

ICPS newsletter

Personal income tax reform discussed in public hearings at the Verkhovna Rada

For years now, the extant personal income tax system has been criticised as hampering the development of the Ukrainian economy, discouraging investment, presenting legal means of avoiding taxation of hefty sums of money, and overburdening the budget with unjustified social subsidies. The problem has not been resolved yet because of the inability of the State Budget to reimburse revenue losses in the first years following the implementation of reforms, even with the help of the tax base expansion. According to experts, the anticipated legalisation of shadow incomes will not come off without proper pension and social security system reform

A series of public hearings on tax reform issues, initiated by the Committee on Finance and Banking Activity of the Verkhovna Rada of Ukraine, the International Centre for Policy Studies (ICPS), and the Support for Economic and Fiscal Reform Project (SEFR), which provided sponsorship, are currently being held. In the course of the public hearings titled "Personal Income Tax: Reform Options", two working groups have been formed, representing the following interest groups: (1) executive government (experts from the Ministry of Finance of Ukraine, State Tax Administration, and Ministry of Economy of Ukraine); (2) Ukrainian businesses; (3) foreign businesses; (4) Ukrainian NGOs; and (5) international organisations. The discussion has focussed on two drafts of the Law of Ukraine "On the tax of personal income", submitted to the Verkhovna Rada by the Ministry of Finance of Ukraine and the Committee on Finance and Banking Activity of the Verkhovna Rada of Ukraine.

Participants of the discussion sought answers to the following questions:

- What problems should changes in the personal income tax solve?
- What are the options for changes in the personal income tax with regard to the tax rate system (a single or differentiated tax rate, assessment of an effective tax rate, and taxation scale), the size of the non-taxable minimum, possibilities for expenditure deduction?
- How will the proposed changes affect the following: (1) business activity; (2) de-"shadowing" of the economy (3) budget

revenues during the first year following the implementation, (4) budget revenues in subsequent years following the implementation, (5) difficulty / ease of tax administration, and (6) possibilities for rent-seeking?

Analysis of the situation

The current situation with the personal income tax system is characterised by exorbitant pressure and the existence of legal means to avoid paying personal income tax.

The existing system overburdens both employees and employers, the latter of which have to pay a payroll tax; hence, tax evasion is often reciprocally agreed. In such a case, significant resources become unavailable for development of the economy. Furthermore, the budget then sustains additional losses, when individuals, concealing their real incomes, obtain subsidies from the budget by claiming that they are poor. The fact that the bulk of the tax burden falls upon people with monthly incomes of up to 800 UAH, while the overly narrow tax base does not allow to diversify budget revenues, maintains the country constantly on the brink of economic shocks.

Analysis of proposed reform options

Both of the draft laws submitted for consideration by the discussion participants demonstrate a common vision of reform paths, shared by the executive government and the parliament: a change in the tax rate scale, a hefty increase in the non-taxable minimum, tax base expansion at the expense of taxation of passive income

Dear readers!

We invite you to participate in the next tax reform discussions. The following tax reform discussions are planned for November 2002:

- Value-added tax: reform options;
- Corporate profit tax: reform options;
- Wrap-up seminar on tax policy.

To register for participation in the public hearings, please contact Tetiana Shvatska at tel. (38-044) 236-3740, 236-4477, or via e-mail: tshvatska@icps.kiev.ua

(dividends, deposit interests, incomes from securities, etc.), cancellation of sectoral benefits, simplification of administration by implementing automatic payroll tax deduction, and minimisation of legal ways of tax avoidance.

The governmental and parliamentary draft laws suggest to implement a tax scale of 10%, 15%, and 20%, simultaneously agreeing with the fact that the bulk of the tax burden should be imposed upon the "middle class"; however, the determined brackets of the middle class vary. The governmental draft law suggests to opt for a mean rate of 15% for people with incomes ranging from 4,800 UAH to 120,000 UAH annually. The parliamentary draft law envisages to introduce a minimum tax rate for annual incomes up to 7,200 UAH, while the maximum rate should be fixed for annual incomes exceeding 72,000 UAH; that is, it actually fixes narrower limits for the middle class.

Both government and parliament representatives agree with the fact that the existing non-taxable minimum does not correspond to real taxation needs and should gradually be adjusted upwards, to either the level of minimum wages or the subsistence minimum. Both speakers emphasised the problem of State Budget losses in the wake of the implementation of such an increase in the first years and proposed to gradually adjust this indicator upwards to the level of the subsistence

minimum; however, specific measures to tackle this problem were not specified in these draft laws. The parliamentary draft law envisages to fix the non-taxable minimum income at 120 UAH [monthly], while the government proposes to economise budget funds and set the non-taxable minimum at 24 UAH monthly.

Regardless of the fact that problems and ways of reforming the personal income tax system have been long discussed, and not only by experts, no changes have been undertaken so far, due to the inability of the State Budget to offset the inevitable short-term losses. Consciously agreeing to the outcome of budget losses, the draft laws' authors hope to compensate these losses at the expense of future money legalisation and the channeling of existing illegal ("shadow") cash flows into the legal economy. Nevertheless, as was emphasised by seminar participants, such legalisation is only possible in the case of all-inclusive reforms, which would include social insurance system reform and pension reform, aiming to create incentives for paying high legal wages; as well as of all legal norms presenting legal ways for tax avoidance.

Opinions agreed on by seminar participants

Representatives of the different groups shared the following opinions:

- the extant legislation on personal income tax is unjust, difficult to administer, creates incentives to avoid paying the personal income tax, and discourages savings;
- any modifications pertaining the extant legislation will galvanise business activity and spur consumption growth, although they would bring less revenues to the Consolidated Budget;
- the deduction of certain expenditures before individual income taxation should be allowed, with certain restrictions imposed upon this right to minimise possibilities of tax avoidance;
- there will be no substantial legalisation of incomes without proper payroll tax reform.

Divergence of opinions of seminar participants

The topics of singular attention was the selection of an optimal tax rate and the tax base expansion. Most seminar participants

favoured the differentiated tax rate and considered the proposed scale (10–15–20 percent) to be altogether acceptable. Advocates of the single tax rate believed that its implementation would speed up the legalisation of incomes.

The discussion demonstrated that there was no agreement regarding the criteria for setting the non-taxable minimum. Some participants agreed that fixing a high non-taxable minimum would result in substantial revenue losses for local budgets, which would have to be offset by augmenting transfers from the State Budget. Therefore, the benefits of decreasing the implicit tax rate would turn out to be smaller than the losses resulting from the State Budget imbalance.

Participants also expressed opposite views regarding the proposal to tax interests on bank deposits. Those who opted for this proposal brought forward the following arguments:

- taxation of interest payments will make the tax system more objective, since this type of income is typical for citizens with high incomes;
- taxation of interest will help to eliminate the possibility of tax avoidance;
- such a decision will allow to partially compensate slumped budget revenues from the reduced tax rates.

Those who opposed the taxation of interest income on bank deposits cautioned that such a decision could lead to reduced deposit volumes, and, consequently, losses in the banking system, and unreasonably high administration expenditures.

Suggestions made by seminar participants

In the course of the discussion, participants brought forward the following suggestions regarding reforms:

- combine the personal income tax reform with reform of the pension system and social security system;
- double taxation of incomes, especially dividends, should be avoided;
- the non-taxable minimum should be increased gradually in order to achieve a subsistence level within five years;
- in order to more accurately evaluate the impact of the reforms on budget revenues, it should be estimated how the reduction of

the tax rate would affect other taxes, specifically, the value-added tax;

- the upper limit of the personal income tax must be harmonised with the corporate profit tax;
- incomes of all household members should be taxed together and not separately;
- benefits should be regulated and their number reduced.

Conclusions

The key dilemma that emerged in the process of discussing personal income tax reforms is, on the one hand, the desire to mitigate the tax burden, and on the other, the desire to prevent substantial revenue budget losses, in particular, of local budgets, which are sustained to an average 65% by personal income tax proceeds. Tax base expansion would allow to only partially offset the budget losses ensuing from the tax rate reduction. The tax receipts would not shrink only thanks to a rapid legalisation of personal incomes; however, this process will drag until the general mandatory and pension insurance system is reformed.

Concurrently, there is no well-defined and consistent reform implementation plan in place. In order to make the mandatory and pension insurance system reforms succeed, apart from economic analysis, different reform options should be evaluated with regard to their implementation. Based on internationally practiced standards for change management, we set forth the following criteria for assessing different options:

- In what way will the process of change management be implemented (planning, coordination, monitoring, assessment, reporting)?
- What are the legislative changes required to implement this reform, and do they comply with European standards?
- In what way should institutional changes occur with regard to already existing institutions, new ones, and their structure, procedures, standards?
- Is there a capacity to implement proposed changes, and what are the skills needed to be developed to ensure successful implementation?
- What financial resources should be mobilised?■

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